Invesco

Emerging Market Macro Insights

Monthly report

Claudia Castro
Portfolio Manager

Wim Vandenhoeck
Senior Portfolio Manager

Thomas Reynolds
Associate Product Manager

Invesco Fixed Income
March 2025

Overview

- Despite market volatility driven by uncertainty over new Trump administration policies, emerging market (EM) local debt has started the year strong.
- Uncertainty over US policies have prompted some EM central banks to take a "wait and see" approach, while others have continued to ease.
- Final tariff outcomes remain uncertain and are the biggest overhang for global growth and US Fed policy, in our view. Given this backdrop, we expect individual country returns to diverge widely in the coming months.
- **Spotlight on Mexico:** Mexico is facing economic challenges and domestic reform, but markets have viewed President Trump's recent delay on tariffs as a positive development for Mexico-US trade relations. Strategic fiscal and trade policies are likely needed for Mexico to sustain economic growth and stability.

EM local debt starts 2025 strong but new US policies create uncertainty

Central bank moves

EM central banks have adopted a "wait and see" approach in the last month as they navigate policy uncertainty under the new US administration. However, a few countries have had room to ease and seized the opportunity. In Latin America, Mexico's central bank accelerated its easing pace to 50 basis points, shifting from a very restrictive policy to one that is less so, but still restrictive. This shift marks a recalibration of monetary policy in light of weakening economic activity and less concern about inflation, which we believe played a significant role in the decision. In Europe, the Czech Republic eased rates by 25 basis points, bringing the rate to 3.75%, as both growth and inflation forecasts have been revised downward. We see the potential for further adjustments aimed at aligning the policy rate more closely to the neutral rate, estimated to be around 3%. In Asia, central banks cut rates by 25 basis points in India, Thailand, and South Korea. A similar theme is playing out there as well: moderating inflation and slower, or expected slower, growth. As President Trump appears to be using tariffs in Asia as a tool primarily to address trade deficits rather than as leverage to negotiate immigration or drug policies, we believe Asia is more vulnerable to slower growth than other regions. This view has prompted central banks in the region to reduce restrictive policies, especially in countries with lower yields.

Market outlook

EM local debt has started the year with strong performance, despite market volatility caused by Trump administration rhetoric on tariffs. Between the one-off use of tariff threats as a bargaining chip, the implementation of more strategic tariffs against China, and the concept of global reciprocal tariffs, there is once again plenty of action to keep investors on their toes.

Additionally, the administration's ad hoc reversals and sometimes conflicting signals have added to the uncertainty. Broad dollar indices have started to weaken, indicating either a stretched long US dollar position or the potential impact of US trade policies, or both. Interest rates have behaved as we have expected, with central banks acting cautiously within their respective frameworks, while remaining aware of potential growth challenges.

Although final tariff outcomes remain uncertain, they remain the biggest overhang for global growth and US Federal Reserve (Fed) policy, in our view. Amid this backdrop, we believe the divergence in returns among countries will be wide. Some countries may have less flexibility than others to counter certain trade policies or may take different approaches in managing the tradeoff between growth and inflation and currency depreciation.

Prevailing trade and geopolitical uncertainties are also forcing some countries to try to reinvigorate their domestic economies. As discussed in previous commentaries, both China and Europe have become incentivized to use fiscal policy to bolster their economies. Ultimately, this could help narrow the gap between the US and the rest of the world, and potentially challenge the US dollar strength seen for over a decade.

Country spotlight: Mexico's persistent economic challenges, shifting external politics and domestic reform

Mexico's economy contracted by more than expected last year, and we expect economic activity to moderate further in 2025, with downside risks. The last quarter of 2024 marked the first decrease in quarterly GDP growth since 2021, and, if the economy experiences a downturn in the first quarter of 2025, it would represent a technical recession. Mexico is facing headwinds caused by restrictive real interest rates, a negative fiscal impulse, soft business confidence and moderate external demand. We expect public investment to decline due to necessary fiscal consolidation, though wage growth has moderated a slowdown in private consumption.

On the external side, Mexico may benefit from foreign direct investment (FDI) flows over the medium-term, driven by nearshoring. Mexico's current account remains well supported by workers' remittances and a declining oil-related trade deficit. Given the outlook for modest growth and a competitive currency, we expect a mild current account deficit this year, with FDI likely able to fully finance it.

We assume that Mexico-US trade relations will progress favorably, as Mexico is inclined to concede to US demands and is coordinating between its government and companies to meet this goal. Both countries agree that policies can be improved and that they both could benefit from deeper integration. We do not rule out bumps along the way, driving uncertainty and asset volatility, given the nature of the relationship.

"Plan Mexico" - President Sheinbaum's plan to promote economic growth

President Sheinbaum has unveiled "Plan Mexico" in response to the new US administration's demands on trade, immigration and drugs. The plan aims to decrease Mexican imports from China, promotes nearshoring via tax deductions, and signals a strong commitment to the United States-Mexico-Canada Agreement (USMCA). It also reflects the government's objective to increase energy generation capacity and natural gas storage capacity. Mexico is well prepared to shape a new Mexico-US relationship, including using targeted retaliatory tariffs if needed. It has leverage that it can use to reduce the likelihood of tariffs or restrictions to the US market, including highly integrated supply chains. However, binding and protracted trade disputes would likely adversely affect economic activity and inflation. We believe risks to traditional economic transmission channels such as trade flows, remittances and industrial cycles are present, and the planned 2026 review of the USMCA adds further uncertainty to the outlook and could delay investment decisions.

Monetary policy

Mexico's central bank, Banco de Mexico (Banxico), lowered its key interest rate by 50 basis points in February, on the back of cooling inflation and weak economic activity late last year. Disinflation and the domestic business cycle both justify the central bank's easing cycle this year, and some board members have started to discuss a similar 50 basis point cut in their next meeting at the end of March. This move coincides with a change in the composition of the Board, which appears more inclined to prioritize growth concerns. However, the central bank will likely remain cautious, considering the significant global uncertainties, such as possible US tariff threats and broader geopolitical risks. While we expect Banxico to distance itself from the Fed if necessary, providing more flexibility for a lower terminal rate, we expect it to retain its commitment to combatting inflation.

Fiscal consolidation

The public deficit in Mexico has increased significantly over the past few years and, as promised in her election campaign, President Sheinbaum announced a fiscal consolidation policy. The budget for 2025 aims to reduce the deficit to 3.9% of GDP, a substantial reduction from the near 5.9% deficit in 2024, helped by aggressive cuts in current and capital expenditures and some optimistic assumptions.[1] The government's fiscal strategy remains focused on improving tax efficiency rather than implementing

1. Source: Bloomberg L.P. Data as of Nov. 15, 2024.

comprehensive tax reform, although we believe tax reform is needed and may be considered over the medium term. While efforts to increase tax collection efficiency have yielded some results, space for further gains has narrowed. On the expenditure side, room to reallocate budgetary resources is now more limited. Additionally, there is less room for discretionary spending or countercyclical fiscal measures, given the rigidity of pensions, debt service and social programs. President Sheinbaum also plans to push for inclusive growth by increasing social spending. Credit rating agencies are watching fiscal outcomes closely to decide whether a rating downgrade is in order this year.

US tariffs

President Trump imposed a 25% tariff on Mexican imports in early March but suspended it just days later. He delayed tariffs for one month following Mexico's progress on illegal immigration and drug trafficking. President Sheinbaum had scheduled a rally in Mexico City on March 9 to announce retaliatory measures surrounding US tariffs, but the rally's focus changed after the US announced the tariff delay. Thousands gathered to celebrate the postponement with President Sheinbaum as she discussed the trade negotiations saying, "Fortunately, dialogue and respect prevailed." The postponement of US tariffs is scheduled to end on April 2, and the world is eager to see if President Trump will follow through on implementing tariffs or continue to use them as a threat for further negotiations.

Conclusion

We believe President Sheinbaum will maintain her predecessor's fiscal prudence and respect for central bank autonomy, as she addresses the challenges of fiscal consolidation and improving the financial situation of state-owned oil company, Pemex. Mexico's medium-term challenges are domestic and likely to persist until a positive structural reform agenda is enabled. These concerns are well recognized and encompass low productivity, significant infrastructure requirements, necessary constitutional reforms, fiscal difficulties and the challenges surrounding Pemex.

New US tariff threats have created more uncertainty and volatility, but President Trump's recent delay on tariffs has been viewed as a victory for Mexico-US trade relations. Although the threat of tariffs remains, President Sheinbaum has expressed optimism that tariffs will not be applied to Mexico, as she continues to work with President Trump on immigration and drug trafficking. President Trump has recognized the Mexican president's initiatives and leadership, and she enjoys strong domestic popularity. Navigating the domestic and external challenges facing Mexico will likely require strategic policies on both the fiscal and trade fronts to sustain growth and stability in Mexico. The economic interdependence, cultural bonds and shared history with the US could potentially form a foundation for deeper integration and a more balanced relationship in the near future.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

Non-investment grade bonds, also called high yield bonds or junk bonds, pay higher yields but also carry more risk and a lower credit rating than an investment grade bond.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

The performance of an investment concentrated in issuers of a certain region or country is expected to be closely tied to conditions within that region and to be more volatile than more geographically diversified investments.

Important information

This document is intended only for professional investors in Hong Kong, for Institutional Investors and/or Accredited Investors in Singapore, for certain specific sovereign wealth funds and/or Qualified Domestic Institutional Investors approved by local regulators only in the People's Republic of China, for certain specific Qualified Institutions and/or Sophisticated Investors only in Taiwan, for Qualified Professional Investors in Korea, for certain specific institutional investors in Brunei, for Qualified Institutional Investors and/or certain specific institutional investors in Thailand, for certain specific institutional investors in Malaysia upon request, for certain specific institutional investors in Indonesia and for qualified buyers in Philippines for informational purposes only. This document is not an offering of a financial product and should not be distributed to retail clients who are resident in jurisdiction where its distribution is not authorized or is unlawful. Circulation, disclosure, or dissemination of all or any part of this document to any unauthorized person is prohibited.

This document may contain statements that are not purely historical in nature but are "forward-looking statements," which are based on certain assumptions of future events. Forward-looking statements are based on information available on the date hereof, and Invesco does not assume any duty to update any forward-looking statement. Actual events may differ from those assumed. There can be no assurance that forward-looking statements, including any projected returns, will materialize or that actual market conditions and/or performance results will not be materially different or worse than those presented.

All material presented is compiled from sources believed to be reliable and current, but accuracy cannot be guaranteed. Investment involves risk. Please review all financial material carefully before investing. The opinions expressed are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals.

The distribution and offering of this document in certain jurisdictions may be restricted by law. Persons into whose possession this marketing material may come are required to inform themselves about and to comply with any relevant restrictions. This does not constitute an offer or solicitation by anyone in any jurisdiction in which such an offer is not authorised or to any person to whom it is unlawful to make such an offer or solicitation.

This document is issued in the following countries:

- in Hong Kong by Invesco Hong Kong Limited 景順投資管理有限公司, 45/F, Jardine House, 1 Connaught Place, Central, Hong Kong.
- in Singapore by Invesco Asset Management Singapore Ltd., 9 Raffles Place, #18-01 Republic Plaza, Singapore 048619.
- in Taiwan by Invesco Taiwan Limited, 22F, No.1, Songzhi Road, Taipei 11047, Taiwan (0800-045-066). **Invesco Taiwan Limited is operated and managed independently.**